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ORIGINAL**BEFORE THE ARIZONA CORPORATION COMMISSION****RECEIVED****COMMISSIONERS**

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2008 JUL 28 P 4: 05

 AZ CORP COMMISSION
 DOCKET CONTROL

IN THE MATTER OF THE REORGANIZATION
 OF VALLEY TELEPHONE COOPERATIVE,
 INC., COPPER VALLEY TELEPHONE, INC.,
 VALLEY CONNECTIONS, LLC, AND VALLEY
 TELECOMMUNICATIONS COMPANY, INC.

DOCKET NO. T-01847A-07-0392
 T-02727A-07-0392
 T-04169A-07-0392
 T-02739A-07-0392

NOTICE OF FILING

Staff of the Arizona Corporation Commission ("Staff") hereby files the Direct Testimony of
 Darron W. Carlson in the above-referenced matter.

RESPECTFULLY SUBMITTED this 28th day of July 2008.

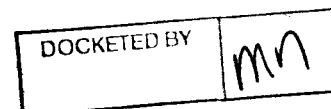
And to for
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 Arizona Corporation Commission
DOCKETED

JUL 28 2008

Original and thirteen (13) copies
 of the foregoing were filed this
 28th day of July 2008 with:

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 Arizona Corporation Commission
 1200 West Washington Street
 Phoenix, Arizona 85007



1 Copy of the foregoing mailed this
28th day of July 2008 to:

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DIRECT

TESTIMONY

OF

DARRON W. CARLSON

DOCKET NOS. T-01847A-07-0392

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TELECOMMUNICATIONS COMPANY, INC.**

JULY 28, 2008

BEFORE THE ARIZONA CORPORATION COMMISSION

MIKE GLEASON

Chairman

WILLIAM A. MUNDELL

Commissioner

JEFF HATCH-MILLER

Commissioner

KRISTIN K. MAYES

Commissioner

GARY PIERCE

Commissioner

IN THE MATTER OF THE REORGANIZATION)
OF VALLEY TELEPHONE COOPERATIVE,)
INC., COPPER VALLEY TELEPHONE, INC.,)
VALLEY CONNECTIONS, LLC, AND VALLEY)
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INTENT TO ORGANIZE A
PUBLIC UTILITY HOLDING
COMPANY

DIRECT

TESTIMONY

OF

DARRON W. CARLSON

PUBLIC UTILITIES ANALYST MANAGER

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JULY 28, 2008

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EXECUTIVE SUMMARY
VALLEY TELEPHONE COOPERATIVE, INC., COPPER VALLEY
TELEPHONE, INC., VALLEY CONNECTIONS, LLC, AND VALLEY
TELECOMMUNICATIONS COMPANY, INC.
DOCKET NOS. T-01847A-07-0392, T-02727A-07-0392,
T-04169A-07-0392, & T-02739A-07-0392

Valley Telephone Cooperative, Inc. ("Cooperative"), Copper Valley Telephone, Inc., ("Copper Valley"), Valley Connections, LLC ("Valley Connections"), and Valley Telecommunications Company, Inc. ("VTC") originally filed a Notice of Intent to (1) organize a public utility holding company and (2) reorganize the ownership interest of Valley Connections with the Arizona Corporation Commission ("Commission") on June 28, 2007. This Notice of Intent proposed to organize VTG Holdings, Inc. ("VTG Holdings") as a holding company for all but one of Cooperative's existing affiliates.

On October 4, 2007, Staff issued a Memorandum and Recommended Order recommending the application be approved without a hearing. Certain valuation and taxation issues were discussed at the subsequent Open Meeting of October 24, 2007. The Recommended Order failed by a vote of 2 to 2.

On March 11, 2008, Cooperative and affiliated companies filed a letter requesting the Memorandum and Recommended Order be scheduled for consideration at the next Open Meeting. At the April 2008 Open Meeting, the Commission approved the Chairman Gleason Proposed Amendment #1 and the Recommended Order, as amended, resulting in Decision No. 70307 (April 24, 2008).

Decision No. 70307 ordered the Commission's Hearing Division to conduct a hearing on the application to address the issues of Finding of Fact Nos. 23 and 24. Additionally, on July 9, 2008, a Procedural Order was issued instructing Staff to file written testimony regarding the aforementioned and discussion of issues raised during the Commission's deliberations of the Recommended Order in October 2007 and April 2008 Open Meetings. Further, Staff's written testimony was to include its response to the written testimony and exhibits filed by Cooperative and the affiliated companies.

After review of the pertinent data, Staff believes that the Cooperative's valuations are unchanged due to the reorganization and formation of the holding company structure. Further, Staff believes that the potential income tax liabilities and/or credits do not require Commission approval.

Staff recommends approval of Cooperative's application. Staff further recommends approval of Staff's original Recommended Order.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Darron W. Carlson. I am a Public Utilities Analyst Manager employed by the
4 Arizona Corporation Commission (“ACC” or “Commission”) in the Utilities Division
5 (“Staff”). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.
6

7 **Q. Briefly describe your responsibilities as a Public Utilities Analyst Manager.**

8 A. In my capacity as a Public Utilities Analyst Manager, I supervise analysts who examine,
9 verify, and analyze utilities’ statistical, financial, and other information. These analysts
10 write reports and/or testimonies analyzing proposed mergers, acquisitions, asset sales,
11 financings, rate cases, and other matters in which they make recommendations to the
12 Commission. I provide support and guidance along with reviewing and editing the work
13 products. I also perform analysis as needed on special projects. Additionally, I provide
14 expert testimony at formal hearings. Finally, I assist Staff members during formal
15 hearings and supervise responsive testimonies as needed during the hearing process.
16

17 **Q. Please describe your educational background and professional experience.**

18 A. I hold a Bachelor of Arts degree in both Accounting and Business Management from
19 Northeastern Illinois University in Chicago, Illinois. I have participated in many seminars
20 and workshops related to utility rate-making, cost of capital, and similar issues. These
21 seminars have been sponsored by the National Association of Regulatory Utility
22 Commissioners (“NARUC”), Duke University, Florida State University, Michigan State
23 University, New Mexico State University, and various other organizations. I have led or
24 actively participated in more than 125 cases before this Commission over the last
25 seventeen years. Since my promotion to management, I have supervised analysts involved
26 in more than 150 additional cases before this Commission.

1 **Q. What is the scope of your testimony in this case?**

2 A. I am presenting Staff's analysis regarding the issues raised during the Commission's
3 deliberations of the Recommended Order at the October 2007 and April 2008 Open
4 Meetings. These issues were more succinctly defined in Decision No. 70307 (April 24,
5 2008) as Finding of Fact Nos. 23 and 24. Additionally, I am presenting Staff's response to
6 the written testimony and exhibits filed by Valley Telephone Cooperative, Inc.
7 ("Cooperative"), Copper Valley Telephone, Inc. ("Copper Valley"), Valley Connections,
8 LLC ("Valley Connections") and Valley Telecommunications Company, Inc. ("VTC").
9 Copper Valley, Valley Connections, and VTC may be referred to collectively as the
10 "Affiliated Companies".

11
12 **Q. Are other members of Staff presenting written testimony in this proceeding?**

13 A. No. However, one additional Staff witness, Mr. Armando Fimbres, may provide oral
14 testimony. Mr. Fimbres sponsored Staff's originally-filed Memorandum and
15 Recommended Order.

16
17 **BACKGROUND**

18 **Q. Please briefly describe the events leading up to the proceeding for which this**
19 **testimony is being provided.**

20 A. Cooperative, Copper Valley, Valley Connections, and VTC originally filed a Notice of
21 Intent to (1) organize a public utility holding company and (2) reorganize the ownership
22 interest of Valley Connections with the Commission on June 28, 2007. This notice
23 proposed to organize VTG Holdings, Inc. ("VTG Holdings") as a holding company for all
24 but one of Cooperative's existing affiliates.

1 On October 4, 2007, Staff issued a Memorandum and Recommended Order
2 recommending the application be approved without a hearing. Certain valuation and
3 taxation issues were discussed at the subsequent Open Meeting of October 24, 2007. The
4 Recommended Order failed by a vote of 2 to 2.

5
6 On March 11, 2008, Cooperative and the Affiliated Companies filed a letter requesting the
7 Memorandum and Recommended Order be scheduled for consideration at the next Open
8 Meeting. At the April 2008 Open Meeting the Commission approved the Chairman
9 Gleason Proposed Amendment #1 and the Recommended Order, as amended, resulting in
10 Decision No. 70307 dated April 24, 2008.

11
12 **Q. What is the purpose of this proceeding?**

13 A. This proceeding is the result of the Commission's deliberations and Decision No. 70307,
14 which orders the Commission's Hearing Division to conduct a hearing on the application
15 to address the issues of Finding of Fact Nos. 23 and 24.

16
17 **Q. Does Staff have any other requirements arising from this proceeding?**

18 A. Yes. The Hearing Division issued a Procedural Order on July 9, 2008, requiring Staff to
19 respond to the written testimony and any related exhibits filed by Cooperative and the
20 Affiliated Companies. Staff will include that response in this testimony.

21
22 **FINDING OF FACT NO. 23**

23 **Q. What is the subject matter of Finding of Fact No. 23?**

24 A. Finding of Fact No. 23 reads as follows: "If the Commission were to approve the proposed
25 reorganization as described in Staff's Memorandum dated October 4, 2007, it appears that
26 VTG Holdings would acquire all shares of the Affiliated Companies, while Cooperative

1 would acquire all shares of VTG Holdings. However, the record in this matter does not
2 address the value of the shares after they have been transferred among the regulated and
3 non-regulated entities.”
4

5 **Q. Is the first sentence of Finding of Fact No. 23 correct?**

6 A. Yes, after completion of the reorganization, VTG Holdings would own all shares of the
7 Affiliated Companies and Cooperative would own all shares of VTG Holdings.
8

9 **Q. How does this reorganization affect the value of the shares of the various entities**
10 **involved in this transaction?**

11 A. In Staff's opinion, the reorganization added no value to, nor removed any value from, the
12 entities involved in the reorganization. All the entities were rearranged under a new
13 organizational chart with no change in value.
14

15 The new entity – VTG Holdings' only value is its ownership of all the shares of the
16 Affiliated Companies. Those share values did not change when relinquished by
17 Cooperative. Cooperative continues to own all of the entities through its ownership of all
18 the shares of VTG Holdings.
19

20 **Q. Will VTG Holdings be regulated by this Commission?**

21 A. No. All of the other entities are regulated (except for the non-profit entities, Valley
22 Telephone Cooperative Foundation (“VTCF”) and Valley Televisions Services
23 Cooperative, Inc. (“VTSC”)). All of the entities, including VTCF, VTSC, and VTG
24 Holdings, are subject to the Commission's Affiliated Interests Rules. The Commission
25 has oversight in all inter-affiliate transactions between all of the various entities involved
26 in this reorganization.

1 **Q. Did Staff do an analysis of the inter-affiliate transfer of Copper Valley's fifty percent**
2 **ownership interest in Valley Connections to Cooperative?**

3 A. Yes. In response to Staff's Data Request No. STF 3.2, Cooperative advised Staff that the
4 transfer of the fifty percent ownership in Valley Connections, for financial statement
5 purposes, was made at net book value so that there was no valuation change and there was
6 no gain or loss recorded. However, for income tax reporting purposes, Copper Valley
7 realized a \$151,391 gain on the transfer. For a full description of the accounting of this
8 transaction, please refer to Cooperative's response to Staff Data Request 3.2 attached to
9 this testimony as Exhibit A.

10
11 **Q. Did this transaction produce any taxable gain?**

12 A. Yes, however that taxable gain was initially deferred in 2006 and will be partially
13 recognized in subsequent tax years as described in Exhibit A.

14
15 **Q. Does Staff believe this inter-affiliate transfer changes the valuation of any of the**
16 **entities involved in the proposed reorganization?**

17 A. No. Staff believes the net share valuations are unchanged.
18

19 **FINDING OF FACT NO. 24**

20 **Q. What is the subject matter of Finding of Fact No. 24?**

21 A. Finding of Fact No. 24 reads as follows: "Staff's Memorandum also indicates that, if the
22 Commission were to approve the proposed reorganization, the companies would allocate
23 income tax liabilities or credits based on their respective contributions of net income or
24 net loss to the consolidated net income or net loss shown on the holding company's
25 consolidated income tax return. However, the record in this matter is silent on the

1 possibility that the allocation of tax liabilities or credits among separate affiliates would
2 require Commission approval.”

3
4 **Q. Is the first sentence of Finding of Fact No. 24 correct?**

5 A. Yes, after completion of the reorganization the income tax liabilities or credits would flow
6 as described above.

7
8 **Q. Does Staff believe that the income tax liabilities or credits incurred by the entities**
9 **would require Commission approval?**

10 A. No. Staff believes the methodology of how the income tax liabilities or credits should be
11 allocated should be determined by Cooperative and/or VTG Holdings. Federal and State
12 income tax regulations already control much of what can be done.

13
14 Staff believes that the central reason for the proposed reorganization is to enable the
15 entities, under VTG Holdings, to file consolidated income tax returns that allow it to take
16 advantage of existing tax laws and minimize its overall tax liabilities.

17
18 **Q. Is Staff concerned that the Commission is relinquishing control of the tax allocation**
19 **process?**

20 A. No, Staff does not believe the Commission is relinquishing any control or responsibility.
21 This Commission continues its oversight as before.

22
23 **Q. What about the difference between the taxable and non-taxable entities involved in**
24 **this proposed reorganization?**

25 A. VTG Holdings is placed below Cooperative on the proposed organizational chart so that in
26 any year in which Cooperative is in a non-taxable status (that is any year in which at least

1 85 percent of its revenue and income is from its membership) it will maintain its non-
2 taxable status and will not file with the other entities. In any year in which Cooperative
3 becomes a taxable entity, it has the ability to file a consolidated return with VTG Holdings
4 and be able to participate in any tax savings derived from that consolidated return.

5
6 VTG Holdings will file income tax returns every year that consolidate the taxable entities
7 Copper Valley, Valley Connections, and VTC.

8
9 **Q. Where are the other non-taxable entities placed in the reorganization?**

10 A. Staff noted that Cooperative's proposed organizational chart included non-taxable VTSC
11 under VTG Holdings. Staff believed that including a non-profit in this group was not
12 appropriate. In response to Staff Data Request 3.3, Cooperative advised that VTSC,
13 although chartered in 1979, has never 1) been funded, 2) had assets, 3) had operations, and
14 4) never filed a tax return. Further, Cooperative advised: "Because it is now deemed to be
15 no longer needed, this entity is pending administrative dissolution, which should occur
16 within the next few months." Under these circumstances, Staff believes VTSC's
17 temporary inclusion in the VTG Holdings group is acceptable.

18
19 Staff notes that non-taxable VTSCF is not included under VTG Holdings in the proposed
20 organizational chart. VTSCF is listed separately, and equivalent to, VTG Holdings under
21 Cooperative.

22
23 **Q. What are the ratemaking implications regarding the tax liabilities or credits under
24 the proposed reorganization?**

25 A. For rates based on cost of service, the normal ratemaking procedure would estimate
26 income taxes on a "stand-alone" basis. That is, without consideration of other entities,

1 that might be included in a consolidated income tax return. The stand-alone basis may
2 produce a lower income tax expense than that produced under the consolidated basis.
3 However, Staff notes that the Commission is not precluded from considering other
4 methods in its rate case analysis.

5
6 **RESPONSE TO TESTIMONY AND EXHIBITS FILED BY COOPERATIVE AND THE**
7 **AFFILIATED COMPANIES**

8 **Q. Has Staff reviewed the testimonies and exhibits filed by Cooperative and the**
9 **Affiliated Companies?**

10 A. Yes. Staff reviewed the testimonies and is in general agreement with Cooperative and the
11 Affiliated Companies. Staff was unable to verify all of the information offered in the
12 testimonies and, therefore, cannot concur with all of the various facts cited. Nevertheless,
13 Staff does concur with the conclusions reached by Cooperative and the Affiliated
14 Companies. Staff believes the proposed reorganization is in the public interest.

15
16 **Q. Does Staff have any comments regarding the exhibits filed?**

17 A. No. The testimonies filed on June 10, 2008, by Cooperative and the Affiliated Companies
18 did not include any exhibits.

19
20 **RECOMMENDATIONS**

21 **Q. What are Staff's recommendations?**

22 A. Staff recommends approval of Cooperative's application. Staff further recommends
23 approval of Staff's original Recommended Order.

24
25 **Q. Does this conclude your Direct Testimony?**

26 A. Yes, it does.

EXHIBIT

A

**RESPONSES TO ARIZONA CORPORATION COMMISSION
STAFF'S THIRD SET OF DATA REQUESTS TO
VALLEY TELEPHONE COOPERATIVE, INC.,
COPPER VALLEY TELEPHONE, INC., VALLEY CONNECTIONS, LLC AND
VALLEY TELECOMMUNICATIONS COMPANY, INC.
DOCKET NOS. T-01847A-07-0392, T-0272A-07-0392, T-04169A-07-0392,
T-02739A-07-0392
JULY 1, 2008**

STF 3.2 Regarding the transfer of 50% ownership interest in Valley Connections on September 30, 2006, please cite the internal revenue service code number allowing this transfer without recognition of capital gains.

Response: The Applicants have attached a letter from their accountant Mr. Bill Miller that responds to this question in detail. Mr. Miller's letter explains the differences between financial statement gains/losses and income tax gains/losses realized by Copper Valley Telephone. During this proceeding, the Applicants have represented that Copper Valley Telephone had no net gain or loss reported on its financial statements from the sale and transfer of its ownership interest in Valley Connections. The Applicants have not stated, nor did they intend to imply in any prior statements, that there were no tax gains/losses from the sale and transfer of Copper Valley Telephone's ownership interest in Valley Connections.

Prepared by: Virgil Barnard
752 E. Maley
Willcox, Arizona 85643

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

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8215 NASHVILLE AVENUE

LUBBOCK, TEXAS 79423

July 3, 2008

Mr. Virgil Banard
Valley Telephone Cooperative, Inc.
Post Office Box 970
Willcox, Arizona 85644

Re: Response to STF 3.2 of Staff's Revised Third Set of Data Requests

Item STF 3.2 of Staff's revised third set of data request states the following:

Regarding the transfer of 50% ownership interest in Valley Connections on September 30, 2006, please cite the internal revenue service code number allowing this transfer without the recognition of capital gains.

Pursuant to our discussion on July 1, 2008, you have requested that we respond to item STF 3.2. Accordingly, we offer the following:

- Assumptions:
 - Sales proceeds \$ 755,099
 - Net book value of 50% ownership interest in Valley Connections at September 30, 2006 \$ 755,099
 - Tax basis of 50% ownership interest in Valley Connections at September 30, 2006 \$ 603,708
- For financial statement reporting purposes, the net gain or loss reported by Copper Valley Telephone for the sale and transfer of its ownership interest in Valley Connections to Valley Telephone Cooperative is \$0. No gain or loss is recognized due to the fact that the cash payment it received from Valley Telephone represented the net book value of its investment in Valley Connections. This is supported by the following calculation:

Sales proceeds	\$ 755,099
Less:	
Net book value of its 50% ownership interest in Valley Connections at September 30, 2006	<u>(755,099)</u>
Net book gain or loss	<u>\$ -</u>

- For income tax reporting purposes, Copper Valley Telephone realized a \$151,391 gain on the sale and transfer of its 50% ownership interest in Valley Connections to Valley Telephone Cooperative. Gain is realized due to the fact that the tax basis of its ownership interest in Valley Connections is less than the net book value by this same amount. The difference in net book value and tax basis is the result of two items. First, Copper Valley Telephone contributed property to Valley Connections during 2005. The net book value and tax basis of this contributed property differed due to accelerated depreciation claimed and deducted on Copper Valley Telephone's tax return prior to the date of contribution. Copper Valley Telephone depreciated this equipment on its books using the straight line method. Secondly, the net book value and the tax basis of Copper Valley Telephone's ownership interest in Valley Connections are impacted by its share of net book income (loss) and reportable taxable income (loss), respectively. The net book income (loss) and the reportable taxable income (loss) of Valley Connections differed, and continue to differ, due to timing differences primarily related to depreciation and the amortization of start up costs. The tax gain realized on this transaction is calculated as follows:

Sales proceeds	\$ 755,099
Less:	
Tax basis of 50% ownership interest in Valley Connections at September 30, 2006	<u>(603,708)</u>
Net tax gain or loss	<u>\$ 151,391</u>

- Copper Valley Telephone realized a \$151,391 gain on the sale and transfer of its ownership interest in Valley Connections to Valley Telephone Cooperative. However, Copper Valley Telephone did not recognize the gain in a corporate income tax return due to the fact that Valley Telephone Cooperative, Copper Valley Telephone and Valley Telecommunications Company filed consolidated federal and state corporate income tax returns. The preparation of a consolidated federal income tax return impacts the recognition of this gain because such gain is the result of an inter-company transaction and inter-company transactions are to be reported and recognized under the "single entity" concept. Specifically, Treasury Regulation 1.1502-13 "Inter-company Transactions" provides that gains and losses are determined on a separate entity

Mr. Virgil Banard
Valley Telephone Cooperative, Inc.
July 3, 2008
Page 3 of 3

basis and then re-determined "...to produce the effect of transactions between divisions of a single corporation (single entity treatment)". For the inter-company sale of a partnership interest (including limited liability company taxed as a partnership, such as Valley Connections), gain or loss is deferred until such time the partnership interest is sold to an outside third party. However, until the partnership is sold, a portion of the deferred gain is recognized as the underlying assets of the partnership are depreciated. This treatment is specifically provided for in Example 9 of Treasury Regulation 1.1502-13(c)(7)(ii). Pursuant to the single entity treatment described above, Copper Valley Telephone deferred the \$151,391 gain in 2006 and began recognizing a portion of the gain in 2007 as the underlying assets of Valley Connections are depreciated for income tax reporting purposes.

We appreciate the opportunity to assist Valley Telephone Cooperative and subsidiaries with its responses to Staff's revised third set of data requests. Should you have questions or need additional information, please do not hesitate to call.

Sincerely,

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

By: *Bill Miller*